Informal Partnerships: Their Status under Federal and State Tax Law

Dana V. Baker

University of Nebraska College of Law
I. INTRODUCTION

An examination of the definition of a partnership for federal income tax purposes quickly reveals a disparity between the federal tax law definition of a partnership and state law definitions.¹ This disparity is a result of the different purposes of Subchapter K of the Internal Revenue Code (Code) and the Uniform Partnership Act (UPA). The rules of Subchapter K of the Code are grounded on certain fundamental income tax principles, while the UPA focuses to a large extent upon the definition of the legal relations and rights among partners.² This divergence of purpose produced a

1. The definition of partnership for federal tax purposes is discussed in § II of text infra. State law definitions of partnership under the Uniform Partnership Act [hereinafter cited as UPA], particularly the Nebraska enactment of the Uniform Partnership Act, NEB. REV. STAT. §§ 67-301 to -343 (Reissue 1976), are discussed in § III of text infra.


Sullivan lists the fundamental income tax principles upon which the rules of Subchapter K are grounded:

Income should be taxed to the person who earned it. [Lucas v. Earl, 281 U.S. 111 (1930)] Income derived from property is to be attributed to the owner thereof. [Helvering v. Horst, 311 U.S. 112 (1940)] The power to dispose is the equivalent of ownership. [Id.] An elemental requirement of a tax system is production of revenue payable to the Government at regular intervals. [Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931)] Profits and losses from the operation of a business are to be treated as ordinary income, and the definition of capital assets must be narrowly applied to prevent the conversion of ordinary income into capital gain. [Corn Products Co. v. Commissioner, 350 U.S. 46 (1955)]

Sullivan, supra, at 108.

Sullivan also points out that the UPA sought to develop a set of rules within which partnerships could satisfactorily operate. His conclusion is based on the observation that more attention was devoted to the legal relations and rights of among partners than to any other phase of partnership activity, and within that area the activities and procedures connected with the severance of partnership relations received more attention than any other subject. Id. at 106.
INFORMAL PARTNERSHIPS

federal tax definition of "partnership" that is broader than state law definitions. Thus, some groups or arrangements will be considered partnerships for federal tax purposes while they are clearly not partnerships under state law. Informal arrangements between parties that are partnerships for federal tax purposes are not so clearly non-partnerships under state law. Informal partnerships involving small farming operations often fall within this gray area. Typical of these types of arrangements are father-son or brother-brother operations in which the parties own separate parcels of farmland, pooling their resources and farming the parcels together while splitting the income and expenses. Despite the frequency of these informal types of arrangements, surprisingly little has been said or written concerning their state versus federal law status. This comment examines the federal and state law classifications of such arrangements and the effect that federal tax laws may have upon parties not desiring partnership status for purposes of state law.

II. PARTNERSHIP FOR FEDERAL TAX PURPOSES

Partnership classification for federal tax purposes can have significant consequences for the parties involved. In some instances, partnership classification results in nonrecognition treatment for current (i.e., nonliquidating) distributions or exchanges of property which would otherwise be treated as taxable sales or exchanges. If an informal arrangement is classified as a partnership,

3. See § II of text infra.
4. If an informal partnership is not a partnership under federal tax law, generally an exchange of property for other property between the parties is treated as a taxable sale or exchange, unless the exchange is a "like kind" exchange. I.R.C. § 1001. No gain or loss is recognized when business or investment property is exchanged for property of "like kind." I.R.C. § 1031. However, a like kind exchange only occurs if the property is of the same nature or character. "[T]he words 'like kind' have reference to the nature or character of the property and not its grade or quality. One kind of class of property may not . . . be exchanged for property of a different kind or class." Treas. Reg. § 1.1031(a)-1(b)(1956). Thus, if a party exchanges a portion of his interest in equipment for a portion of interest in real estate, a taxable exchange occurs. Such an exchange is treated as if the interest in equipment was sold for the fair market value of the real estate received. I.R.C. § 1001. On the other hand, if the informal partnership is classified as a partnership under the federal tax laws, such an exchange would be characterized as a current (i.e., nonliquidating) partnership distribution and no gain or loss would be recognized by the parties or the partnership. Under I.R.C. § 731(a), the recipient of a current distribution generally recognizes neither gain nor loss. The sole exception to this rule occurs when the distribution includes an amount of money in excess of the distributee's basis in his or her partnership interest. The distributing partnership also does not recognize gain or loss on the distribution. I.R.C. § 731(b).
the presence of a written or oral partnership agreement can control important tax conclusions.\(^5\) The Code also provides that elections affecting computation of taxable income for a partnership shall be made by the partnership.\(^6\) If the Internal Revenue Service (Service) treats the informal arrangement as a partnership, some elections made by the parties as individuals that must be made by the partnership may be ineffective.\(^7\) For example, elections made

\(^5\) The presence of provisions in the partnership agreement controls important tax conclusions in five distinct instances provided by the Code:

1. The partners' distributive shares of taxable income or loss of the partnership (§ 704(a)).
2. The partners' distributive shares of a particular class of income, gain, loss, deduction, or credit, which may differ from shares of general income or loss (§ 704(b)).
3. Special allocation to the partners of depreciation, depletion, or gain or loss with respect to interests in property contributed by partners (§ 704(c)(2)).
4. Allocation to the partners of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed by the partners (§ 704(c)(3)).
5. Characterization of payments made to a retiring or deceased partner as being for his interest in goodwill (§ 736(b)(2)(B)).

\(^6\) I.R.C. § 703(b) reads:

(b) Elections of the Partnership—Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under section 901, relating to taxes of foreign countries and possessions of the United States, and any election under section 617 (relating to deduction and recapture of certain mining exploration expenditures), under section 57(c) (relating to definition of net lease), and any election under section 163(d) (relating to limitation on interest on investment indebtedness), shall be made by each partner separately.

\(^7\) Elections that must be made by the partnership include:

(2) the method used in computing depreciation with respect to partnership property;
(3) the election to amortize the costs of emergency facilities (§ 168) and grain storage facilities (§ 169);
(4) the choice of inventory method;
(5) the election to reinvest condemnation proceeds in qualifying property and thereby avoid the recognition of gain on condemnations pursuant to § 1033;
(8) the election to deduct additional first year depreciation (§ 179);
(9) the election to defer cancellation-of-indebtedness income under § 108;
(10) the election to expense land-clearing costs under § 182;
(11) the election of a taxable year (§ 706(b)); and
(12) the election to report gain under the § 453 installment method

by the individual parties with respect to property, such as the election to capitalize interest and carrying charges\(^8\) and the election to reinvest the proceeds from involuntary conversions of property without recognition of gain,\(^9\) would be ineffective.\(^10\) Thus, for parties entering into or already involved in informal arrangements, their status under federal tax law can have significant tax consequences as well as an effect on their state law status.\(^11\)

A. "Partnership": The Statutory Definition

The term "partnership" is defined broadly for tax purposes and may include groups not commonly called partnerships. The Code states "the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not within the meaning of this title, a corporation or a trust or estate."\(^12\) The breadth of the definition is emphasized by section 1.761-1(a) of the regulations, which states that the term "is broader in scope than the common law meaning of partnership."\(^13\) Yet, section 761 does not provide a clear test for

---

\(^8\) I.R.C. § 266.
\(^9\) I.R.C. § 1033.
\(^10\) 1 MCKEE, supra note 7, ¶ 3.01[3].
\(^11\) This comment is primarily concerned with the effect partnership status may have upon state law status. Thus, the tax consequences of federal partnership status are not examined further. Since the federal tax definition is examined, the consequences of federal tax status and the importance of determining the federal tax status is mentioned here.
\(^12\) I.R.C. § 761. I.R.C. § 7701(2) defines partnership in an identical fashion.
\(^13\) The regulation reads:

(a) Partnership.—(1) In general. The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Internal Revenue Code of 1954. The term “partnership” is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. See section 7701(a) (2). See regulations under section 7701(a) (1), (2), and (3) for the description of those unincorporated organizations taxable as corporations or trusts. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere coownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if coowners of an apartment building
determining whether a partnership exists. On the contrary, it states only that a partnership includes a syndicate, group, pool, joint venture or other unincorporated organization, which is engaged in a business, financial operation, or venture. Apparently, under the section 761 definition, partnerships are jointly-owned, profit-oriented arrangements that occupy the territory between the more precisely defined joint ownership arrangements (i.e., corporation trusts and estates) and other profit-motivated arrangements in which two or more participants have separate, rather than joint financial interests.\textsuperscript{14} In contrast to the rather well-defined boundary between partnerships and the more precisely defined joint ownership arrangements, the boundary between partnerships and arrangements lacking sufficient jointness to be classified as partnerships has been described by one commentator as a "shifting no-man's land."\textsuperscript{15} The problem of informal arrangements is determining whether the arrangement falls within this area.

B. Federal Law is Determinative

Long before the enactment of Subchapter K of the Code by Congress in 1954, the Supreme Court had ruled that federal law, rather than common law or state law, is controlling for issues involving income taxes. In \textit{Hecht v. Malley}\textsuperscript{16} and \textit{Burk-Waggoner Oil Association v. Hopkins}\textsuperscript{17} the Court held that "Massachusetts trusts" were associations within the meaning of the Revenue Act of 1918 and therefore taxable as corporations despite the fact they were partnerships under the state law of Texas and either pure trusts or partnerships under the state law of Massachusetts.\textsuperscript{18} This logic also applies under Subchapter K. Thus, an arrangement may be a partnership for federal tax purposes when it is not, and could not be, one for state law purposes. For example, in \textit{Olmstead Hotel v. Commissioner},\textsuperscript{19} the court held that a state law trust created by four married couples to operate a hotel was to be treated as a partnership for tax purposes\textsuperscript{20} and a state law trust was also

\begin{itemize}
  \item lease space and in addition provide services to the occupants either directly or through an agent.
  \item Treas. Reg. § 1.761-1(a) (1956). \textit{E.g.,} Treas. Reg. § 301.7701-3(a) (1960).
  \item 1 McKee, \textit{supra} note 7, § 3.02.
  \item Id. The work also notes that "the intensely factual character of this aspect of the partnership definition makes generalizations [concerning the boundary] difficult." \textit{Id.} § 3.6.
  \item 265 U.S. 144 (1924).
  \item 269 U.S. 110 (1925).
  \item Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 113-14 (1925); Hecht v. Malley, 265 U.S. 144, 161 (1924).
  \item 11 T.C.M. (P-H) ¶ 52,209 (1952).
  \item Id. at 697. The Commissioner had argued the trust was an association taxable as a corporation because the trust could survive the death of any owner
\end{itemize}
held to be a partnership for federal tax purposes in Revenue Ruling 64-220.\textsuperscript{21} Furthermore in \textit{Evans v. Commissioner},\textsuperscript{22} the court held an assignment of a one-half partnership interest to a corporation effected termination of the partnership for tax purposes even though the assignor remained a partner under state law, observing that "for federal income tax purposes, Federal Tax law is controlling . . . and the legality, or lack of thereof, of a partnership under State law does not determine whether a partnership exists for federal tax purposes."\textsuperscript{23} In \textit{Haley v. Commissioner},\textsuperscript{24} the court found a partnership for tax purposes because the agreements and the conduct of the parties indicated the existence of such a relationship. The court found an intent to enter into it, despite the parties' express statements in their agreements that they did not intend to enter into a partnership or a joint venture.\textsuperscript{25}

Moreover, a partnership under state law is not necessarily a partnership for federal tax purposes. The Supreme Court in \textit{Com-
missioner v. Tower\textsuperscript{26} upheld the Tax Court's denial of partnership status for a husband and wife for tax purposes even though their partnership agreement would have been valid under Michigan law. The Court's response to the respondent's contention that validity under Michigan law should control with respect to validity for tax purposes, was that it was not governed in its determination by how Michigan law might treat the same circumstances for state law purposes. "Michigan cannot, by its decisions and laws governing questions over which it has final say, also decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax levied against earned income."\textsuperscript{27}

Nevertheless, state law must be considered in analyzing these relationships because it may be considered as a factor in determining whether a partnership exists for federal tax purposes. In Buckley v. United States,\textsuperscript{28} the court relied upon the fact that a partnership existed under Mississippi law in holding that a partnership existed for federal tax purposes.\textsuperscript{29} Under Mississippi law, a partnership did not need to be predicated upon a written agreement, but could be inferred from the circumstances and conduct of the parties. Thus, a state law partnership existed between a professor of journalism and one of his former students with respect to a newspaper publishing business they had purchased where there was an oral agreement to share profits and the professor's conduct evidenced intent to form a partnership.\textsuperscript{30} The arrangement's state law status was expressly considered by the court in making its determination that a partnership also existed for tax purposes.

Status under state law has also been held to be determinative with regard to the type or nature of the property interest held for purposes of nonrecognition treatment for involuntary conversion gains under section 1033. In M.H.S. Co.,\textsuperscript{31} the Tax Court deter-

\textsuperscript{26} 327 U.S. 280 (1946).
\textsuperscript{27} Id. at 288. See also United States v. Kinter, 216 F.2d 418 (9th Cir. 1954), where the Service was arguing that an association of medical doctors was a partnership for tax purposes because associations of doctors could not be corporations under state law. The court held that despite its state law status, the association was taxable as a corporation: "Groups which could not engage in certain activities under State law because of their particular structure, or were considered partnerships have been recognized as legitimate 'associations' partaking of corporate character for taxing purposes under federal law." Id. at 423.
\textsuperscript{28} 76-1 U.S.T.C. (CCH) ¶ 9473 (W.D. Tex. 1976).
\textsuperscript{29} "Whether a partnership existed for federal tax purposes is to be determined by federal law, although local law is relevant to such an analysis." Id. at 84,313. E.g., Haley v. Commissioner, 203 F.2d 815 (5th Cir. 1953).
\textsuperscript{30} The professor exercised managerial perogatives, negotiated financing for the business and permitted the business to be represented to the community as a partnership. 76-1 U.S.T.C. (CCH) ¶ 9473, at 84,313.
\textsuperscript{31} 45 T.C.M. (P-H) ¶ 76,165 (1976), aff'd, 575 F.2d 1177 (6th Cir. 1978).
minded that under Tennessee law, a company's condemnation award for real estate actually had been reinvested in a state law partnership. Since under Tennessee law an interest acquired in a partnership is an interest in personality regardless of the fact that the underlying assets of the partnership include interests in real property, the Tax Court denied nonrecognition of gain under section 1033 for lack of a "like kind" property exchange. Thus, although informal arrangements must look to federal law to determine whether their arrangement is a partnership for tax purposes, state law should not be disregarded in evaluating their tax status and the tax treatment of various arrangements between the parties involved.

C. "Partnership": The Federal Income Tax Definition

The Code does not attempt a specific definition of "partnership." Consequently, for a definition of partnership one must look to case law. The landmark cases setting forth what constitutes a partnership for federal income tax purposes are Commissioner v. Tower, and Commissioner v. Culbertson. In Tower, the Supreme Court upheld the Tax Court's conclusion that the existence of a partnership had not been established. In its decision, the Court stated a definition of partnership for income tax purposes:

A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses. When the existence of an alleged partnership agreement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is, question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.'

The Tower decision has been interpreted as establishing certain specific criteria for determining whether a partnership exists. However, the Supreme Court in Culbertson rejected the
idea that partnerships are defined by reference to any specific factors.

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.40

Thus, the fundamental question since Culbertson in determining the existence of a partnership for tax purposes has been the intent of the parties.41 This intent test focuses, however, on the intention to carry on a business or venture for joint economic gain, rather than the intention to be treated as a partnership for state law or tax purposes.42 Determination of this intent requires an examination of all the surrounding circumstances. Culbertson and later court decisions have listed the following factors as evidencing that intent: (1) the agreement of the parties and their conduct in executing its terms; (2) a purpose of carrying on a trade or business; (3) the contribution of capital or services which each party made to the enterprise; (4) the parties' control over income and capital and their right to make withdrawals; (5) Whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses; (6) whether the parties exercised mutual control and assumed mutual responsibilities for the enterprise; (7) whether separate books of account were kept for the enterprise; (8) whether business was conducted in the joint names of the parties and how title to business property was held; and (9) the parties' indications

40. Id. at 742 (footnote omitted). According to the Court, the facts which should be considered include:

the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent . . . .

Id.

41. William N. Gurtman, 34 T.C.M. (CCH) 475 (1975). Gurtman involved the issue of whether the parties to a written agreement for the manufacture and sale of tanks and boilers were in a joint venture recognizable for tax purposes. In deciding the question, the court considered the same principles which govern the question of partnership existence for tax purposes. Thus, the fundamental issue was "whether the parties intended to, and did in fact, join together for the accomplishment or conduct of an undertaking or enterprise." Id. at 480 (citing Hubert M. Luna, 42 T.C. 1067, 1077 (1964); Commissioner v. Culbertson, 337 U.S. 733, 741-42 (1949)). The court in its resolution of that question, considered "all the facts and circumstances in light of the factors, none of which alone is determinative, bearing on the issue." Id. See, e.g., Hubert M. Luna, 42 T.C. 1067 (1964).

42. 1 McKee, supra note 7, ¶ 3.02[1].
to others that the enterprise is or is not a partnership. Further evidence of intent that may be taken into account by the courts include: (1) a separate bank account; (2) an employer's identification number; (3) registration of a fictitious name; and (4) whether a federal partnership tax return is filed.

No one factor is controlling, nor is the lack of any factor specifically determinative. Enterprises which possess all the characteristics would clearly be partnerships for income tax purposes. The problem is determining the tax status of arrangements that carry only some evidence of intent. The resulting difficulty in ascertaining the intent of the parties through application of the foregoing indicia has led to considerable disparity in the opinions of the courts and the rulings of the Service. One commentator has observed:

Despite the Supreme Court's indication in Culbertson that a partnership is not defined by reference to any specific or set of factors, it seems that three requisites must generally be satisfied if an enterprise is to be classified as a partnership for tax purposes.

(1) the enterprise must be formed for the purpose of producing profits;
(2) the profits generated by the enterprise must be shared jointly by two or more persons; and
(3) two or more of the persons sharing the profits must do so as proprietors.

This approach may not be characteristic of the types used by most courts and the Service in the ascertainment of the parties' intent, but it is helpful as a starting point in determining whether a partnership exists for tax purposes.

The typical small farming operation involving father-son or brother-brother will satisfy those three requisites since: (1) the parties have pooled their resources in order to farm successfully; (2) the parties split the profits from the farming operations; and (3) their profit interests usually reflect their co-ownership of the machinery and/or real estate involved in the farming operations. In addition, the parties usually share expenses. Each of them contributes substantial services to the farming operations, and each has authority to make purchases for the operations. However, when their arrangement is informal and they have not considered themselves to be organized as a separate entity, several of the indicia of partnership may be absent: (1) separate books of account

43. Commissioner v. Culbertson, 337 U.S. 733 (1949); Hubert M. Luna, 42 T.C. 1067 (1964); Edward C. James, 16 T.C. 930 (1951), aff'd per curiam, 197 F.2d 813 (8th Cir. 1963).
44. 1 A. Willis, supra note 5, at 5.
46. See generally 1 A. Willis, supra note 5, at 5-10.
47. 1 MCKEE, supra note 7, ¶ 3.02[2].
have not been kept for the enterprise; (2) the operation has not been conducted in their joint names; (3) they may not have been holding themselves out to others as a partnership; (4) the enterprise generally does not have a separate bank account or an employer's identification number; and (5) federal partnership income tax returns may not have been filed in the past. Consideration of all the facts and circumstances of such operations reveals the parties' intent under the Culbertson test to carry on a business for joint economic gain. Thus, they are a partnership for tax purposes regardless of their desires.

D. Informal Partnerships in Federal Estate Tax Cases

When the Culbertson intent test is applied to father-son or brother-brother farming operations, the indicia of intent leads one to the conclusion that they are a partnership for federal income tax purposes. The inclusion of such arrangements within the breadth of the federal tax law definition of partnership is clearly illustrated by the cases in the federal estate tax area involving claims of informal partnerships between husbands and wives for the purpose of equalizing their estates in order to reduce estate taxes.48 Despite the fact that these informal partnership cases are estate tax cases and the existence of the partnership is argued by the taxpayer rather than the Service, they apply the same test and rationale as the income tax cases for the purpose of determining the existence of a partnership.

48. By equalizing the estates of the spouses, the surviving spouse has ownership of approximately one-half of the couple's property and the estate of the deceased member of the marital union is reduced or increased accordingly. Equalization is designed to protect against the situation where the first spouse to die holds a large majority of the "marital property" and, thus, a large amount of estate tax is due at that time. When their estates are equalized, the combined estate tax liability for both may be reduced because of the graduated rates and oftentimes the estate tax on one-half of the property deferred until the death of the surviving spouse.

Estate of Everett Otte, 31 T.C.M. (CCH) 301 (1972), is an example of such an estate equalization case. Otte involved a husband and wife who had developed a substantial farming operation subsequent to their marriage. They had bought the land together and held it as tenants by entirety. The wife, besides being a housewife, had helped substantially in the farming operations. The husband died and the wife was arguing that one-half of the personal and real property was actually her own and should not be included in the decedent's estate. Although the court never explicitly considered whether an informal partnership had existed between the two, it held they had worked as a "husband and wife" team and the wife had contributed an adequate and full consideration in money and money's worth in the acquisition of her one-half interest in all the real and personal property. Therefore, one-half of all the real and personal property should not be included in her deceased husband's estate, and the estate tax liability was reduced accordingly.
In one such estate tax case, *Craig v. United States*, the wife argued that only fifty percent of the personal property involved in the family farming operation should have been included in her deceased husband's estate. She contended that she was entitled to have one-half of the personal property involved in the farming operation treated as her own because she had been in partnership with her husband. The court stated the critical issue was the *Culbertson* intent test, "not whether the capital or services contributed by a partner are of a certain quality to meet some objective standard but rather whether 'the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.'" The court then found that the evidence indicated the husband and wife had in fact pooled their capital and labors with the good faith intent to conduct a family partnership in the establishment, operation, and growth of the family farm. Thus, the wife was held entitled to have one-half of the personal property treated as her own. In ascertaining the husband and wife's intent, the court looked at the capital contributions of both parties, the division of labor, the contributions of both parties in the operation of the farm, and the fact that all major decisions of the business were decided on the basis of equal participation by both husband and wife throughout their marriage as they built a sizeable and profitable operation from scratch.

A similar conclusion was reached in *United States v. Neel*, which upheld a trial court decision that an informal partnership had existed between a wife and her deceased husband. The evidence showed that shortly after their marriage, the couple had pooled their money without express agreement, and thereafter each had made substantial contributions of labor and services to joint undertakings in farming, business, and the practice of law. Once again the court applied the *Culbertson* intent test. Despite the absence of an express agreement, the court found it could be reasonably and fairly implied from the facts that the deceased and his wife had agreed to contribute substantial services, to jointly manage and carry on as partners, and to share equally in the profits and losses. The court's response to the lack of an express agreement was that it was not necessary to prove an express partnership agreement. Instead, the agreement could be implied from their conduct.

In determining whether a husband and wife were bona fide business partners...

50. *Id.* at 381-82 (quoting Commissioner v. Culbertson, 337 U.S. 733, 742 (1949)).
51. 451 F. Supp. at 381.
52. 235 F.2d 395 (10th Cir. 1956).
53. *Id.* at 400.
partners with respect to tax liability, the absence of a formal agreement and the failure to set up books as partners is not conclusive. Neither is it essential that written articles of partnership be prepared and executed. A partnership agreement may be oral and may result from the acts and conduct of the parties clearly manifesting an intention to engage in a bona fide business partnership. 54

Since an informal partnership had existed between the wife and her deceased husband, only one-half of the property standing in the deceased's name as well as one-half of the joint bank accounts were included in the decedent's gross estate. 55

These family arrangements were scrutinized by the courts to determine whether the parties really intended in good faith to join together their money, labor and skill for the purpose of carrying on a business as a bona fide partnership. 56 Father-son and brother-brother farming operations would also be subject to similar scrutiny in the income tax area. In light of the above cases it is apparent that the typical father-son or brother-brother operation would be determined a partnership for tax purposes under the federal law.

III. PARTNERSHIPS UNDER STATE LAW

Under state law, a partner generally is liable for all torts committed and all contractual obligations incurred by his partners in connection with the partnership business, 57 while a mere co-owner's liability for the torts and contractual obligations of another co-owner is strictly limited. 58 Since joint ownership does not necessarily establish a partnership under state law, 59 the parties in informal arrangements such as father-son or brother-brother farming arrangements may desire not to be partners for those reasons. If this is their desire, their status as a partnership for federal tax purposes does not necessarily mean that they are also a partnership under state law and their state law status should therefore be closely examined.

A. The Determination of Partnership Existence

The state law definition of partnership is not as broad as the federal tax definition. The Uniform Partnership Act defines a partnership as an association of two or more persons, to carry on as co-

54. Id. at 400.
55. Id. at 396.
57. UPA § 15; NEB. REV. STAT. § 67-315 (Reissue 1976).
58. UPA § 7(2); NEB. REV. STAT. § 67-307(2) (Reissue 1976).
59. UPA § 25(d); NEB. REV. STAT. § 67-325(2)(d) (Reissue 1976).
owners, a business for a profit.\textsuperscript{60} In its enactment of the Uniform Partnership Act, Nebraska amended that definition to read: "A partnership is an association of persons \textit{organized as a separate entity} to carry on a business for profit."\textsuperscript{61} Yet, no formal means are necessary for two parties to create a partnership.\textsuperscript{62} Thus, in determining whether a partnership exists under the UPA, the courts will examine the facts of each case in the light of several criteria.\textsuperscript{63} Although different jurisdictions vary on the criteria that are to be used, most have referred to the following factors as essential: profit sharing, loss sharing, intention to form a partnership, right of control, and various types of community of interest.\textsuperscript{64}

The only element which appears to be absolutely essential in the determination is profit sharing.\textsuperscript{65} Section 7 of the UPA\textsuperscript{66} states that profit sharing is prima facie evidence of partnership unless it falls within some limited exceptions.\textsuperscript{67} However, despite profit sharing's high evidentiary status, it may be overcome by other evidence showing that the parties intended no partnership.\textsuperscript{68}

Nebraska case law has defined a partnership as "a contract of

\begin{itemize}
  \item[60.] UPA § 6(1); Neb. Rev. Stat. § 67-306(1) (Reissue 1976).
  \item[63.] \textit{See, e.g.}, Pruitt v. Fett, 146 W.Va. 275, 278, 134 S.E.2d 713, 716 (1964).
  \item[64.] 1 S. Rowley, \textit{Partnership} 40, 163 (2d ed. 1960).
  \item[65.] \textit{Id.}
  \item[66.] § 7 Rules for Determining the Existence of a Partnership—In determining whether a partnership exists, these rules shall apply:
    \begin{enumerate}
      \item Except as provided by section 16 persons who are not partners as to each other are not partners as to third persons.
      \item Joint tenancy, tenancy in common, tenancy by the entirety, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.
      \item The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.
      \item The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:
        \begin{enumerate}
          \item As a debt by installments or otherwise,
          \item As wages of an employee or rent to a landlord,
          \item As an annuity to a widow or representative of a deceased partner,
          \item As interest on a loan, though the amount of payment vary with the profits of the business.
          \item As the consideration for the sale of a goodwill of a business or other property by installments or otherwise.
        \end{enumerate}
    \end{enumerate}
  \item[68.] \textit{E.g.}, Troy Grain \& Fuel Co. v. Rolston, 227 S.W.2d 66 (Mo. App. 1950).\
\end{itemize}
two or more competent persons to place their money, effects, labor, skill, or some or all of them, in lawful commerce or business, and to divide the profit or bear the loss in certain proportions.\textsuperscript{69} Carlson \textit{v. Peterson}\textsuperscript{70} sets forth the test for determining the existence of a partnership: "[t]he existence of a partnership depends upon \textit{the agreement of the parties, and their intention} is to be ascertained from all the evidence and circumstances of a case."\textsuperscript{71} The intention of the parties is important because Nebraska law defines a partnership as a consensual relationship. The parties’ intent can be present in an express or implied agreement\textsuperscript{72} but their agreement need not be evidenced by a written contract.\textsuperscript{73} For instance, in \textit{Baum v. McBride},\textsuperscript{74} the court held that a partnership existed where the evidence showed two parties had entered into an oral agreement to combine their assets and conduct a company on an even partnership basis.

Other jurisdictions have held it is not necessary that the parties have knowledge they have entered into a partnership when the intent is implied.\textsuperscript{75} The Nebraska Supreme Court has not considered that question to date. However, the definition of partnership in section 67-306 of the Nebraska Revised Statutes requires an association of persons organized as a separate entity,\textsuperscript{76} and the cases refer to partnerships as being consensual relationships. If an express intention exists between the parties not to be treated as a partnership, implied intent to enter into a partnership should not be so easily established, especially in view of the fact that the burden of establishing the existence of a partnership is upon the party asserting the relationship exists.\textsuperscript{77}

Assuming the parties to informal farming arrangements do not want to be treated as a partnership, what would be the outcome of a third party claiming that a partnership exists?

First, the parties in such arrangements often split profits, which is prima facie evidence of a partnership. Second, many of the facts and circumstances of their farming operations will usually indicate an implied intent to operate as a partnership, even if they are un-

\textsuperscript{69} Peterson v. Massey, 155 Neb. 829, 834, 53 N.W.2d 912, 916 (1952); Baum v. McBride, 143 Neb. 629, 630, 10 N.W.2d 477, 478 (1943); Waggoner v. First Nat'l Bank, 43 Neb. 84, 94, 61 N.W. 112, 116 (1894).
\textsuperscript{70} 130 Neb. 806, 266 N.W. 608 (1936).
\textsuperscript{71} \textit{Id.} at 812, 266 N.W. at 611 (emphasis added). \textit{See}, e.g., Baum v. McBride, 143 Neb. 629, 10 N.W.2d 477 (1943).
\textsuperscript{73} \textit{Id.}
\textsuperscript{74} 143 Neb. 629, 10 N.W.2d 477 (1943).
\textsuperscript{75} Jenkins v. Harris, 19 Tenn. App. 113, 121, 83 S.W.2d 562, 567 (1935).
\textsuperscript{76} \textit{NEB. REV. STAT.} § 67-306 (Reissue 1976).
\textsuperscript{77} Peterson v. Massey, 155 Neb. 829, 835, 53 N.W.2d 912, 916 (1952).
ware of that fact. In light of these facts, the major question would be the effect of an express intention of the parties not to be a partnership for state law purposes, especially if the parties had drawn up transactions to buttress that express intention. The fact they have never intended to organize their operations as a separate entity for the purpose of farming, and representations to third parties that they are not a partnership are additional facts to be considered. It appears it is difficult for them to overcome a presumption of partnership resulting from profit splitting and facts implying an intent of partnership. Generally, the substance of an arrangement will control over its form, thus if the parties do not want to be treated as a partnership for state law purposes, the less partnership-like the conduct of their farming operation appears, the more likely an express intention not to operate as a partnership will be upheld.

B. The Effect of Filing a Federal Partnership Tax Return

The filing of a partnership tax return by parties in informal arrangements such as father-son or brother-brother farming arrangements may have adverse consequences on a desire not to be treated as a partnership under state law. Despite the fact that the state law definition of partnership is not coextensive with the federal tax definition, the filing of a federal partnership tax return might be considered by a state court as evidence of intent to be a partnership, or as an admission that a partnership exists. For example, in *Falkner v. Falkner*, the court affirmed the lower court's finding that a partnership existed between a son, his father, and his brother, even though they had dealt with each other in a casual way and had not kept any records. The son brought the action seeking one-third interest in certain lands and personal property, and for an accounting out of the alleged partnership. In affirming the lower court's determination that the alleged partnership did exist and that the remaining funds should be divided equally between the parties, the court stated that the strongest evidence in support of the decision was the fact that partnership tax returns were filed for the years 1953 through 1965, which indicated some intention that a partnership existed and the trial judge was entitled to consider it as such.

The filing of partnership tax returns has also been considered in determining whether a partnership existed under state law. In *Boxill v. Boxill*, in determining that a partnership had existed between a sister and brother in the operation of a rooming house,

---

the court found that the existence of a partnership as claimed by the sister was indicated by ample and persuasive confirmatory evidence even though the agreement between the parties was not in writing. 80 The court listed the execution of the lease for the rooming house by the sister and the brother, the contribution of the money by the sister to take and furnish the premises, the sharing of the profits and losses between them, and the filing of partnership income tax returns 81 as some of the persuasive confirmatory evidence.

Because the federal tax law definition and the state law definition of partnership are not coextensive, the wisdom of considering the filing of a federal partnership tax return as evidence of the existence of a state law partnership is questionable. Not all courts take such an approach. In Keller v. Keller, 82 the court held the fact that an income tax return had designated the deceased husband's wife as a partner and had reflected distribution of partnership income to her did not establish the existence of partnership, particularly where there was evidence that the payment had been made for tax reasons.

The Nebraska Supreme Court, as well as many other state courts, has not stated in its decisions dealing with partnership existence whether it will consider the filing of a federal partnership tax return as evidence of partnership existence. The fact that some states have done so places parties in informal arrangements in a dilemma when their informal arrangement is a partnership for federal tax purposes and they do not desire to be a partnership for state law purposes. If the parties file a federal partnership tax return, the return may well result in evidence of the existence of the state law partnership that they wish to avoid.

IV. CONCLUSION

In light of the dilemma that parties may be placed in by their federal tax status and their intention under state law, a suggested course of action would be to forego filing a partnership tax return in spite of their partnership status for federal tax purposes. Apparently, the Service allows small partnerships to abstain from filing partnership returns as long as each partner files a detailed statement of his share of partnership income and deductions with his own return. In the committee report 83 to section 211(a) of the

---

80. Id. at 36.
81. Id.
82. 4 Ill. App. 3d 89, 280 N.E.2d 281 (1972).
Revenue Act of 1978,84 the committee recognized such an exemption for small partnerships (those with ten or fewer partners) from section 211(a)'s penalty for failure to file a partnership return.85 Given the Service's apparent acquiescence, parties in such a dilemma should be able to abstain from filing partnership tax returns, despite their federal tax status, as long as they accurately reflect their income and deductions on their individual returns. Their status as partnerships under the federal tax laws and the benefits that may arise from that status should not be impugned by their decision not to file partnership returns. Thus, the state law status of such informal arrangements would not be affected by their status under the broader federal tax definition, and the theoretical ill effects arising from the differences in the definitions of partnership would not exist in a practical sense.

Dana V. Baker '79


85. The penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause. The committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. Although these partnerships may technically be required to file partnership returns, the committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance.